Looking At Investing From A New Perspective, A Half Century Old

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I'm honored to be here with you investment professionals today, especially in this lovely city on this beautiful day. When your Board members learned that I would be in Malibu to give a lecture at Pepperdine on "Artistic Entrepreneurship and Technology," they kindly invited me to meet with you during my visit. I was delighted to accept, and I appreciate your coming to this luncheon on such short notice.

It's ironic that at my lecture tomorrow my remarks will revolve around the theme of my previous book, *The Battle for the Soul of Capitalism*, published by Yale University Press in October 2005. In *Battle* I discuss, among other things, the failure of our new "agency society" that has developed over the past five decades, supplanting our old "ownership society," now long gone and never to return. Today, financial institutions hold 68 percent of the shares of the stocks of all U.S. corporations, a dramatic change from 1950, when only 8 percent of shares were held by institutions and 92 percent were owned directly by individual investors.

A major part of that failure reflects the traditional "agency problem" described by economists—the fact that, paraphrasing Adam Smith, "corporate directors and managers of other people's money seldom watch over it with the same anxious vigilance that they watch over their own. Like the stewards of a rich man, they very easily give themselves a dispensation." This is as true of executive compensation in corporate America as it is of management fees in mutual fund America. The shareholders of both, alas, dine at the bottom of the food chain—the harsh reality of our business.

Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.

But another large part of the failure of our agency society relates to the change in the focus of our two largest financial institutions—mutual funds, now holding 30 percent of all stocks, and public and private pension funds, now holding nearly 20 percent—from the wisdom of long term investing to the folly of short term speculation. The irony is that, in many respects, that sea change in investment focus is the subject of my brand new book, *The Little Book Of Common Sense Investing*, with an official "publication date" just a week from now.

My concern, expressed in *The Little Book*, is that investors today—as well as the investing public and our giant financial institutions focus on the illusory *expectations* market, rather than the *real* market of intrinsic business value. While business value changes only gradually, expectations change in real time, and stocks change hands with incredible rapidity. While the turnover of U.S. stocks averaged about 20 percent during the 1950s, 1960s, and 1970s, it rose to around 50 percent during the 1980s through the early 1990s, crossed 100 percent in 1998(for the first time since 1929) and has been running at an amazing 150 percent since then. This quantum increase in investment activity, to state the obvious, can't enrich stockholders as a group. But it is surely a blessing to the croupiers of Wall Street (even at today's vastly diminished commission *rates)*.

This new book, subtitled *The Only Way to Guarantee Your Fair Share of Stock Market Returns*, focuses on the simple, straightforward, and, I think, unarguable premise that all of this activity is extremely harmful to the wealth of investors . . . . in fact, to the tune of about $400 billion per year. Why? Because of these simple facts; (1) that owning American business for the long term is a *winning* game (businesses, after all, earn a return on their capital and distribute a major part of those earnings or dividends); (2) that beating the market (*before* the costs of financial interdiction) is a *zero-sum* game; and (3) that beating the market *after* costs is a *loser's* game. I call these obvious principles "the relentless rules of humble arithmetic," in the long-ago words of Supreme Court Justice Louis D. Brandeis.

The Index Fund

The way to guarantee your fair share of the returns generated by business, of course, is to hold the market portfolio and eliminate all intermediation costs. While I'm confident that this room holds many skeptics about indexing, I'm equally confident that there is also a significant group here that agrees with my reasoning. This reasoning has almost *nothing* to do with "indexing" as such, and almost *everything* to do with simply owning U.S. business (or global business) in its entirety, through a capitalization-weighted portfolio of our total stock market, and then holding that portfolio for Warren Buffett's favorite holding period: "forever".

Simply put, if an investor buys the market portfolio, pays no sales loads, no management fees, tiny operating costs, and no portfolio transaction costs, and holds it forever, that investor will capture virtually 100 percent of the stock market's annual return. On the other hand, for the average investor buying actively-managed funds (or for that matter, engaging in any strategy that involves heavy trading), usually carrying commissions, substantial management fees, heavy operating and marketing costs, huge costs of portfolio turnover (the average equity fund now turns its portfolio over at an astonishing rate of 100 percent per year!), that investor's return will fall far short of the market's return.

How far short? Well, those all-in mutual fund costs that I just enumerated presently come to something like 2 ½ percent of assets per year. Since the average mutual fund manager is, well, average—you heard it here!—the return of the average fund has fallen short of the return of the Vanguard 500 Index fund by about 2 ½ percentage points over the past quarter century. And simply because of those costs, the average fund is destined to fall short by a similar amount in the years to come.

Now let's assume that we're fortunate enough to enjoy future nominal returns in the stock market averaging 7 percent per year, roughly what reasonable expectations suggest for the coming decade. (We can talk about that later.) Let's also assume that the inflation rate will be about 2 ½ percent, leaving a 4 ½ percent real stock market return. If equity fund costs continue at today's 2 ½ percent rate (and there's no evidence that they are declining), they would confiscate about 60 percent of that *annual* real return.

But don't stop there. *Compounded* over an investment lifetime—say, 50 years—$10,000 invested at 4 ½ percent (let's make it 4.4 percent to take into account the minimal costs of an index fund) would produce a real profit of $76,100. On the other hand, $10,000 invested at a return of 2 percent (net of that 2 ½ percent cost) would grow by just $16,900 in real terms. Rather than taking the road less traveled by—passively owning the entire market—the investor who travels the traditional road of active management would earn less than 25 percent of a stock market profit that is there for the taking. (The exact figure is 22 percent.)

The Gotrocks Family

Even before you think about index funds, however, think about the eerie nature of our financial system. Using my version of a parable from Warren Buffett's letter in the Berkshire Hathaway 2005 Annual Report (it's in the *Little Book*), here's how investing actually works:

Once upon a Time . . . a wealthy family named the Gotrocks, grown over the generations to include thousands of brothers, sisters, aunts, uncles, and cousins, owned 100 percent of every stock in the United States. Each year, they reaped the rewards of investing: all the earnings growth that those thousands of corporations generated and all the dividends that they distributed. Each family member grew wealthier at the same pace, and all was harmonious. Their investment had compounded over the decades, creating enormous wealth, because the Gotrocks family was playing a winner's game.

But after a while, a few fast-talking Helpers arrive on the scene, and they persuade some "smart" Gotrocks cousins that they can earn a larger share than the other "dumb" relatives. These Helpers convince the cousins to sell their shares in overvalued companies to other family members and to buy shares of undervalued companies from them in return. The Helpers handle the transactions, and as brokers, they receive commissions for their services. The ownership is thus rearranged among the family members.

To their surprise, however, the family's share of the generous pie that U.S. industry bakes each year—all those dividends paid, all those earnings reinvested in the business—100 percent at the outset, starts to decline, simply because some of the return is now consumed by the Helpers. To make matters worse, while the family had always dutifully paid taxes on their dividends, some of the members are now also paying taxes on the capital gains they realize from their stock-swapping back and forth, further diminishing the family's total wealth.

The smart cousins quickly realize that their plan of rearranging stock ownership among the family members has actually diminished the rate of growth in the family's wealth. They recognize that their foray into stock-picking has been a failure, and conclude that they need professional assistance, the better to pick the right stocks for themselves. So they hire stock-picking experts—more Helpers!—to gain an advantage. These money managers charge a fee for their services. So when the family appraises its wealth a year later, it finds that its share of the pie has diminished even further.

To make matters still worse, the new managers feel compelled to earn their expensive keep by trading the family's stocks at feverish levels of activity, not only increasing the brokerage commissions paid to the first set of Helpers, but running up the tax bill as well. Now, of course, the family's earlier 100 percent share of the dividend and earnings pie is further diminished.

"Well, we failed to pick good stocks for ourselves, and when that didn't work, we also failed to pick managers who could do so," the smart cousins say. "What shall we do?" Undeterred by their two previous failures, they decide to hire still more Helpers. They retain the best investment consultants and financial planners they can find to advise them on how to select the right managers, who will then surely pick the right stocks. The consultants, of course, tell them they can do exactly that. "Just pay us a fee for our services," the new Helpers assure the cousins, "and all will be well." Alas, the family's share of the pie tumbles once again.

Alarmed at last, the family sits down together and takes stock of the events that have transpired since some of them began to try to outsmart the others. "How is it," they ask, "that our original 100 percent share of the pie—made up each year of all those dividends and earnings—has dwindled to just 60 percent?" Their wisest member, a sage old uncle, softly responds: "All that money you've paid to those Helpers and all those unnecessary extra taxes you're paying come directly out of our family's total earnings and dividends. Go back to square one, and do so immediately. Get rid of all your brokers. Get rid of all your money managers. Get rid of all your consultants. Then our family will again reap 100 percent of however large a pie that corporate America bakes for us, year after year."

They followed the old uncle's wise advice, returning to their original passive but productive strategy, holding all the stocks of corporate America, and standing pat . . . and the Gotrocks Family Lived Happily Ever After.

Business Reality Trumps Market Expectations

That wonderful parable brings home the central reality of investing: "The most that owners in the aggregate can earn between now and Judgment Day is what their business in the aggregate earns," in the words of Warren Buffett. Illustrating the point with the stock of Berkshire Hathaway, Buffett says, "When the stock temporarily overperforms or underperforms the business, a limited number of shareholders—either sellers or buyers—receive out-sized benefits at the expense of those they trade with. [But] over time, the aggregate gains made by Berkshire shareholders must of necessity match the business gains of the company."

How often investors lose sight of that eternal principle! Yet the record is clear. History, if only we would take the trouble to look at it, reveals the remarkable, if essential, linkage between the cumulative long-term returns earned by business—the annual dividend yield plus the annual rate of earnings growth—and the cumulative returns earned by the U.S. stock market. Think about that certainty for a moment. Can you see that it is simple common sense?

Need proof? Just look at the record of stock returns over the past 100 years. The average annual total return on stocks was 9.6 percent, virtually identical to the *investment* return of 9.5 percent—4.5 percent from dividend yield and 5 percent from earnings growth. That tiny difference of 0.1 percent per year, arose from what I call speculative return. Depending on how one looks at it, merely statistical noise, or perhaps it reflects a generally upward long-term trend in stock valuations, a willingness of investors to pay higher prices for each dollar of earnings at the end of the century than at the beginning.

Compounding these returns over the century produced accumulations that are truly staggering. Each dollar initially invested in 1900 at an investment return of 9.5 percent grew by the close of 2005 to $15,062. Sure, few (if any) of us have a century of life in us (yet!), but, like the Gotrocks family over the generations, the miracle of compounding returns is little short of amazing—the ultimate winner's game. The problem is that this miracle of compounding *returns* is overwhelmed by the tyranny of compounding *costs.* If we assume even 2 percent in annual costs, that 9.5 percent nominal return drops to 7.5 percent, and the accumulated capital drops to just $2,100—less than one-seventh as much.

In our foolish focus on the short-term stock market distractions of the moment, we, too, often overlook this long history. We ignore that when the returns on stocks depart materially from the long-term norm, it is rarely because of the economics of investing—the earnings growth and dividend yields of our corporations. Rather, the reason that annual stock returns are so volatile is largely because of the emotions of investing. Put another way, while illusion (the momentary prices we pay for stocks) often loses touch with reality (the intrinsic values of our corporations), in the long run it is reality that rules.

To drive this point home, think of investing as consisting of two different games. Here's how Roger Martin, dean of the Rotman School of Management of the University of Toronto, describes them. One is "*the real market*, where giant publicly held companies compete, where real companies spend real money to make and sell real products and services, and, if they play with skill, earn real profits and pay real dividends. This game also requires real strategy, determination, and expertise; real innovation and real foresight." Loosely linked to this game is another game, *the expectations market*. Here, "prices are not set by real things like sales margins or profits. In the short-term, stock prices go up only when the expectations of investors rise, not necessarily when sales, margins, or profits rise."

The expectations market is about speculation. The real market is about investing. The only logical conclusion: the stock market is a giant distraction that causes investors to focus on transitory and volatile investment expectations rather than on what is really important—the gradual accumulation of the returns earned by corporate business. And the costs of financial intermediation involved in actively participating in a financial markets dramatically erode those cumulative returns.

The Rise of the ETF

The simple and unarguable arithmetic that I've laid out here is what leads logically to superiority of the index strategy. I've been talking about it, arguably, since 1951, when I mentioned the failure of mutual fund managers to beat the market (even then!) in my Princeton senior thesis. But it took me until 1975 to start the world's first index mutual fund (Vanguard Index 500), and its tiny $11 million IPO was something of a failure ("Bogle's folly"). But over the next quarter century, indexing took hold, and today the assets of index mutual funds now total more than $1 trillion, about 16 percent of the assets of all equity funds. But it is ironic that while mutual fund indexing continues to grow apace, the means by which investors index has taken a U-turn—a U-turn for the worse. *Classic* indexing has been overwhelmed by what I call indexing *nouveau*, represented by the exchange traded fund (ETF).

The ETF is simply an index fund designed to facilitate trading in its shares, dressed in the guise of the *traditional* index fund. Think of the differences: First, if long-term *investing* was the original paradigm for the classic index fund of 30 years ago, surely using index funds as trading vehicles can only be described as short-term *speculation*. Second, if the broadest possible diversification was the original paradigm, surely holding discrete—even widely-diversified—

sectors of the market offers less diversification and commensurately more risk. Third, if the original paradigm was minimal cost, it's clear that holding market sector index funds that are themselves low-cost obviates neither the brokerage commissions entailed in trading them nor the tax burdens incurred if one has the good fortune to do so successfully.

And as to the fourth and final, quintessential aspect of the original paradigm—assuring, indeed guaranteeing, that you will earn your fair share of the stock market's return—the fact is that an investor who *trades* ETFs—and especially sector ETFs—has nothing even resembling such a guarantee. The typical ETF investor has *absolutely no idea* of what relationship his or her investment return will bear to the return earned by the stock market itself. But, after all of the selection challenges, the timing risks, the extra costs, and the added taxes, I'd bet on a substantial shortfall. (Think Gotrocks here.)

But the fact is that, despite the demonstrated success of the classic indexing strategy over three decades now, the growth in market share of traditional index funds stopped dead in 1999, at 10 percent of equity fund assets. All of the increase since then—the remaining 6 percentage points of that 16 percent total has come in ETFs. This stampede into exchange traded funds (ETFs) has been dominated overwhelmingly by highly specialized funds that, in the words of an ETF advertisement, "can be traded in real time, all day long." Among 690(!) ETFs today, 678 are narrowly focused, some on individual foreign countries (Korea, Germany, whatever you wish) or industry sectors (technology, small-caps, even most recently, HealthShares Emerging Cancer). Only 12 of the 690 ETFs are highly diversified index funds holding the entire U.S. stock market or the entire non-U.S. stock market, close cousins to our diversified blue-chip funds of yore. Of course such ETFs, held for the long term, are perfectly fine investments. But actively pursuing these popular narrow strategies that drive the ETF business, too often chasing past performance, will surely be hazardous to the wealth of our investors and in the long-run, that can't be good for our industry.

All things considered, the burgeoning growth of ETFs *is* a dream come true for fund managers, industry entrepreneurs, financial advisers, and brokers. They offer the excitement of a new idea, massive publicity, and the marketing flexibility of the fund industry's asset gatherers to focus on whatever sectors are hot and whatever strategies have paid off in the recent past, all the better to attract the capital of performance-hungry investors. But is it too much to ask whether these index funds nouveau are an *investor's* dream come true? I don't think that they are. Indeed, in a real sense, the ETF is a *trader to the cause* of classic indexing. I urge investment professionals to stay the course with the proven strategy. *While I can't say that classic indexing is the* ***best*** *strategy ever devised, I can assure you that the number of strategies that are* ***worse*** *is infinite.*

Creating Indexes that Beat the Market. The New Paradigm?

It is a curious irony that the ETF has been adopted as the format for the new "fundamental" indexes. This "new breed" of indexers—although they are not, in fact, indexers, but active strategists—focuses on weighting portfolios by so-called "fundamental" factors. Rather than weighting by market cap, they use a combination of factors such as corporate revenues, cash flows, profits, or dividends. (For example, the portfolio is weighted by the dollar amount of dividends distributed by each corporation, rather than the dollar amount of its market capitalization.) They argue, fairly enough, that in a cap-weighted portfolio, half of the stocks are overvalued to a greater or lesser extent, and half are undervalued.

The traditional indexer responds: "Of course. But who really knows which half is which." The new fundamental indexers unabashedly answer, "we do." *They claim to know which is which.* And—this will not surprise you—the fundamental factors they have identified as the basis for their portfolio selections actually *have* outpaced the traditional indexes in the past. (We call this "data mining." For you can be sure that no one would have the temerity to promote a new strategy that has *lagged* the traditional index fund in the past.)

Even including this recent advantage, the long-term margins of superiority achieved by these theoretically-constructed back-tested portfolios are not large—between 1 and 2 percentage points per year over the cap-weighted S&P 500 Index. How much of that edge would have been confiscated by their expense ratios? (The lowest is 0.28 percent; the average is about 0.50 percent; the highest that I've seen is 1.89 percent.) How much would have been confiscated by their extra portfolio turnover costs compared to the classic index funds? How much would have been confiscated by extra taxes paid by shareholders when that turnover results in gains? Even if the modest margins claimed in the past were to repeat—which I believe is highly unlikely—these back-tested hypothetical returns, ignoring fund expenses, sales charges, and portfolio turnover costs, would be significantly eroded if not totally erased by those costs.

When managers of traditional active equity funds claim to have a way of uncovering extra value in our highly- (but not perfectly-) efficient U.S. stock market, investors will look at their past record, consider the manager's strategies, and then invest or not. These new index managers are in fact active managers. But they not only claim prescience, but a prescience that gives them confidence that most sectors of the market (such as dividend-paying stocks) will remain undervalued for as far ahead as the eye can see. But, if these factors *are* underpriced, why won't investors, hungry to capitalize on that apparent past inefficiency, bid up prices until the undervaluation no longer remains? Put another way, if these promoters of the purported new paradigms actually have been *right* in the past, won't they therefore be *wrong* in the future?

Interestingly, the choice of the ETF structure—rather than the standard mutual fund format—by these confident entrepreneurs would seem to belie the fact that their "fundamental indexing" approach may take decades to prove itself, if indeed it does so at all. Because by choosing the ETF format, they imply even more strongly that investors who actively buy and sell their new fundamental funds will lead to even larger short-term profits than buying and holding them for the long term.

I recommend skepticism about these purported "new paradigms." I've witnessed too many new paradigms over the years. None has persisted. The "concept" stocks of the Go-Go years in the 1960s came, and went. So did the "Nifty Fifty" era that soon followed. The "January effect" of small-cap superiority came, and went. Option-income funds and "Government plus" funds came, and went. In the late 1990s, high-tech stocks and "new economy" funds came as well, and even today the asset values of the survivors remain far below their peaks. Intelligent investors should approach with extreme caution a claim that *any* new paradigm is here to stay. That's not the way financial markets work.

We do know that traditional low-cost all-market-cap-weighted index funds guarantee that you will receive your fair share of stock market returns, and virtually assure that you will outperform, over the long term, 90 percent or more of the other investors in the marketplace. Maybe this new paradigm of "fundamental" indexing—unlike all the other new paradigms I've seen—will work. But maybe it won't, too.

I urge you investment professionals not to be tempted by the siren song of paradigms that promise the accumulation of wealth that will be far beyond the rewards of the classic index fund. Don't forget the prophetic warning of Carl von Clausewitz, military theorist and Prussian general of the early 19th century, "the greatest enemy of a good plan is the dream of a perfect plan." *Put your dreams away,* I would warn investors, *and stick to the good plan represented by the classic index fund.*

What Would Benjamin Graham Have Thought About Indexing?

So of course I'm troubled by this era's focus on what I regard as potentially counterproductive investment strategies. In writing in my *Little Book* about these truths about how our financial system actually works, why classic indexing is the ultimate winning strategy, and puzzling over the trading index funds is—so popular and whether there are new "paradigms" that assure beating the market from now till doomsday, I mused about what the legendary Benjamin Graham might have thought about these developments. I'd studied his wonderful book *The Intelligent Investor,* published in 1949, and decided to see what I could discover.

Although Graham is best known by far for his focus on the kind of value investing represented by the category of stocks he describes as "bargain issues," he cautioned, "the aggressive investor must have a considerable knowledge of security values—enough, in fact, to warrant viewing his security operations as equivalent to a business enterprise . . . It follows from this reasoning that *the majority of security owners should elect the defensive classification*."

Why? Because "[the majority of investors] do not have the time, or the determination, or the mental equipment to embark upon such investing as a quasi-business. They should therefore be satisfied with the reasonably good return obtainable from a defensive portfolio, and they should stoutly resist the recurrent temptation to increase this return by deviating into other paths." He noted that Wall Street is "in business to make commissions, and that the way to succeed in business is to give customers what they want, trying hard to make money in a field where they are condemned almost by mathematical law to lose." (Drop the "almost," and there is the Gotrocks family!)

In *The Intelligent Investor*, Graham commended the use by investors of leading investment funds as an alternative to creating their own portfolios. Graham described the well-established mutual funds of his era as "competently managed, making fewer mistakes than the typical small investor," carrying a reasonable expense, and performing a sound function by acquiring and holding an adequately diversified list of common stocks. But he was bluntly realistic about what fund managers might accomplish. Even *excluding* the oppressive impact of sales loads, Graham's view was that fund returns "were not very impressive . . . on the whole, the managerial ability of invested funds has been just about able to absorb the expense burden and the drag of uninvested cash."

Graham's timeless lesson for the intelligent investor, as valid today as when he described it in his book, is clear: "the real money in investment will have to be made—as most of it has been made in the past—not out of buying and selling but of owning and holding securities, receiving interest and dividends and increases in value," again exemplified in the distinction between the business market and the expectations market that I mentioned earlier.

Owning and holding a diversified list of securities? Wouldn't Graham recommend a fund that essentially buys the entire stock market and holds it forever, patiently receiving interest and dividends and increases in value? Doesn't his admonition to "strictly adhere to standard, conservative, and even unimaginative forms of investment," eerily echo the concept of market indexing? When he advises the defensive investor "to emphasize diversification more than individual selection," hasn't Benjamin Graham come within inches of describing the modern-day stock index fund?

Late in his life, in an interview published in 1976, Graham candidly acknowledged the inevitable failure of individual investment managers to outpace the market. He was asked, "Can the average manager obtain better results than the Standard & Poor's Index over the years?" Graham's blunt response: "No." Then he explained: "In effect that would mean that the stock market experts as a whole could beat themselves—a logical contradiction."

Then he was asked whether investors should be content with earning the market's return. Graham's answer: "Yes." Finally, he was asked about the objection made against the index fund—that different investors have different requirements. Again, Graham responded bluntly: "At bottom that is only a convenient cliché or alibi to justify the mediocre record of the past. All investors want good results from their investments, and are entitled to them to the extent that they are actually obtainable. I see no reason why they should be content with results inferior to those of an indexed fund or pay standard fees for such inferior results."

Graham was also well aware that the superior rewards he had reaped using his valuation principles would be difficult to achieve in the future. In that 1976 interview, he made this remarkable concession, "I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, but the situation has changed a great deal since then. In the old days, any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost."

It is Benjamin Graham's common sense, clear thinking, simplicity, and sense of financial history—along with his willingness to hold fast to the sound principles of long term investing—that constitute his lasting legacy. He sums up his advice: "Fortunately for the typical investor, it is by no means necessary for his success that he bring the time-honored qualities . . . of courage, knowledge, judgment and experience . . . to bear upon his program—provided he limits his ambition to his capacity and confines his activities within the safe and narrow path of standard, defensive investment. To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks." When it's so easy—in fact unbelievably simple—to capture the stock market's returns through an index fund, you don't need to take extra risks—and wasteful costs—in striving for superior results. With Benjamin Graham's long perspective, common sense, hard realism, and wise intellect, there is no doubt whatsoever in my mind that he would have applauded the index fund, and I say just that in my *Little Book.*

Now, the surprising denouement. Last autumn, I happened to have dinner with Warren Buffett in Omaha (at Gorat's, of course). He asked how the new book was coming, and I made so bold as to ask him whether he thought I had gone too far with my conclusion that Ben Graham would have endorsed the index fund. Without a moment's hesitation Warren (who was Graham's protégé and collaborator in the final edition of *The Intelligent Investor*) replied, "*I know he would*. He told me so himself, saying that 'A low-cost index fund is the most sensible equity investment for the great majority of investors.' Ben Graham took this position many years ago, and everything I have seen convinces me of its truth." (Of course, I used this endorsement on the book's back cover).

Wrapping Up

Let me conclude with a stunning example of the effectiveness of traditional indexing, and then offer a few final words. At a dinner last September celebrating the 30th anniversary of the initial public offering of "First-Index Investment Trust" (now Vanguard 500 Index Fund), the counsel for the fund's underwriters reported that he had purchased 1000 shares at the original offering price of $15.00 per share—a $15,000 investment. The value of his holding that evening (including dividend reinvestment), he proudly announced, was $461,771. Now there's a number that requires no comment. (Well, maybe one comment. Of the 360 equity mutual funds then in existence, only 211 remain today.)

I hope that my bluntness today about the merits of classic all-market index funds has not pushed you beyond your tolerance. But if you aren't persuaded by what such index funds have accomplished during their 30-year history, at least reflect on the underlying reasons for their success; no more than common sense, simplicity, and the relentless rules of humble arithmetic, broad diversification, low expense ratios, no sales loads (and no aggressive marketing), and minimal portfolio turnover, held by investors for the long-term and guaranteed to give them their full share of whatever returns the financial markets are generous enough to provide.

If you disagree with my broad characterization of what the mutual fund industry has become—to the detriment of its shareholders—at least focus your efforts on that relatively small handful of fund organizations that have been investors rather than marketers; that have kept fees and turnover low; that have resisted the lure of asset gathering and of creating new funds for every purpose; and don't consider their funds as "products," made by "manufacturers," to be sold to "consumers." (These are the words that are increasingly used as this profession of yore has gradually mutated into the business of today. I'll bet most of you here today hate those words as much as I do!)

There is, in this intriguing field that we investment professionals share, something called "the greater good." It is putting service of our investor clients above service to ourselves. And that should be the underlying principle for any investment firm and any investment professional who wants to make the field of investing a worthwhile lifetime endeavor. Can you do? Of course you can. Take heart from these eternal words which happen to have appeared in the *Financial Analysts Journal in 1963*, written by, of all people, Ben Graham:

"It is my basic thesis—for the future as for the past—that an intelligent and well-trained Financial Analyst can do a useful job as portfolio adviser for many different kinds of people, and thus amply justify his existence. He can do this by adhering to relatively simple principles of sound investment; e.g., a proper balance between bonds and stocks; proper diversification; selection of a representative list; discouragement of speculative operations not suited for the client’s financial position or temperament—and for this he does not need to be a wizard in picking winners from the stock list or in foretelling market movements.”

“Be all this as it may, of one thing I am certain. Financial analysis in the future, as in the past, offers numerous different roads to success. Many will gain it by way of an intensive knowledge of one or more industries; others by specializing in technology; others by an outstanding ability to evaluate the management factor; still others by flair for the public’s psychology—perhaps even specializing in fantasy; others, again, will have a good nose for bargains and be experts in special situations of all sorts. For men and women with real ability in one or more of these many directions, financial analysis (or security analysis) will continue to offer highly satisfactory rewards.”